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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.

Rulemaking 06-04-009
(Filed April 13, 2006)

**ADMINISTRATIVE LAW JUDGE'S RULING
REQUESTING COMMENTS AND NOTICING WORKSHOP
ON ALLOWANCE ALLOCATION ISSUES**

1. Summary

Today's ruling requests comments on issues related to the distribution of greenhouse gas (GHG) emission allowances, which were first discussed at a June 22, 2007 workshop held at the California Energy Commission (Energy Commission) in this joint Public Utilities Commission and Energy Commission proceeding. While that workshop focused on emission allowance issues related to a load-based cap for the electricity sector, this ruling also addresses allowance allocation-related issues for a deliverer/first seller approach and also for the natural gas sector, consistent with amendments to the rulemaking adopted in Decision (D.) 07-07-018 and D.07-05-059.

Parties are invited to file comments on the questions contained in this ruling, and any other issues they deem to be related to this topic. Parties may file comments no later than October 31, and reply comments no later than November 14, 2007. A workshop will be held commencing at 10:00 a.m. on November 5, 2007, at the Energy Commission, which will allow the Commissions

and stakeholders to explore the recommendations and positions presented in the October 31, 2007 comments. This workshop will be webcast. A draft agenda and instructions for accessing the webcast will be posted on the Energy Commission website and e-mailed to the service list in this rulemaking.

2. Background and General Instructions

Determination of the manner in which GHG regulations will be implemented in California consistent with Assembly Bill (AB) 32 will be the responsibility of the California Air Resources Board (ARB). In this proceeding, the Commissions will determine what type of approach is most appropriate for the electricity and natural gas sectors, in order to make recommendations to ARB.

On June 22, 2007, Energy Commission and Public Utilities Commission Staff jointly conducted a workshop to address the interrelated topics of (1) ARB's process for development of the 1990 GHG emissions baseline and related underlying assumptions for the electricity sector; (2) "current" retail provider-specific GHG emissions levels in the electricity sector; and (3) policy issues related to retail provider-specific GHG emission allowance allocation. The stated intent of the workshop was to focus on current emissions levels and entity-specific allocations to implement a load-based cap for the electricity sector in California.

Procedurally, it was decided at the June 22, 2007 workshop to (1) await the issuance of ARB's 1990 baseline values in mid-to-late July before determining whether the Public Utilities Commission and the Energy Commission should make recommendations to ARB regarding the 1990 baseline; (2) issue a Joint Staff (Energy Commission and Public Utilities Commission) data request seeking information from parties regarding current retail provider-specific GHG

emissions levels; and (3) refine and reissue the pre-workshop questions regarding emission allowance allocation policy issues, to provide parties an additional opportunity to file comments on emission allowance allocation policy issues. Accordingly, on July 17, 2007 the Joint Staff issued a data request regarding current retail provider-specific GHG emissions levels.

No decisions have been made by the Public Utilities Commission, the Energy Commission, or ARB about the ultimate design of the GHG regulatory framework for the electricity and natural gas sectors, including whether a cap and trade system should be implemented. The questions in this ruling explore policy issues related to the distribution of emission allowances if a cap and trade system is adopted. Since the Public Utilities Commission and the Energy Commission have not issued recommendations regarding the point of regulation in the electricity sector (e.g., load-serving retail providers or deliverers/first sellers), this ruling includes questions regarding allowance allocations under both structures.

Questions in this ruling regarding the distribution of emission allowances in the natural gas sector assume that (1) the point of regulation would include natural gas distribution companies (whether investor- or publicly-owned), interstate pipeline companies, and natural gas storage companies,¹ and (2) these entities would be responsible for emissions from operations (transmission, storage, and distribution of natural gas delivered to all end-use customers in California) and from combustion of natural gas by all end users except electricity

¹ While D.07-05-059 provided that this proceeding will consider proprietary natural gas pipeline operators and entities that have their own facilities and natural gas supplies, we do not address them in this ruling.

generation and the large natural gas users that ARB plans to regulate as point sources. The efficacy of the assumptions underlying the questions in this ruling will be addressed separately in this proceeding.

Regardless of the chosen point of regulation, under a cap and trade system, two basic options exist for distribution of emission allowances: they may be auctioned or they may be allocated administratively. A third option is some combination of the two, whereby some emission allowances are auctioned and the rest allocated administratively. Variations for auctioning and allocating emission allowances are addressed in this ruling.

3. Questions to be Addressed in Comments

Each commenter should explain the reasons for its answers to each of the following questions. While individual questions address details, the final question asks each commenter to present its overall recommendation regarding the manner in which emission allowances should be distributed if a cap and trade system is adopted.

3.1. Evaluation Criteria

Developing evaluation criteria may help the Commissions analyze the issues surrounding emission allowance allocation issues. For example, the final report of the Market Advisory Committee (MAC) includes a discussion of emission allowance distribution and recommends that California should “strive to distribute allowances in a manner consistent with fundamental objectives of cost-effectiveness, fairness, and simplicity,” and should “distribute allowances in

a manner that advances the following principles,” which are copied and numbered below:²

- a. Reduces the cost of the program to consumers, especially low-income consumers,
 - b. Avoids windfall profits where such profits could occur,
 - c. Promotes investment in low-GHG technologies and fuels (including energy efficiency),
 - d. Advances the state’s broader environmental goals by ensuring that environmental benefits accrue to overburdened communities,
 - e. Mitigates economic dislocation caused by competition from firms in uncapped jurisdictions,
 - f. Avoids perverse incentives that discourage or penalize investments in low-GHG technologies and fuels (including energy efficiency),
 - g. Provides transition assistance to displaced workers, and
 - h. Helps to ensure market liquidity.
- Q1. Please comment on each of the criteria listed by the MAC. Are these criteria consistent with AB 32? Should other criteria be added, such as criteria specific to the electricity and/or natural gas sectors? In making trade-offs among the criteria, which criteria should receive the most weight and which the least weight?

3.2. Basic Options

These questions should be answered for both the electricity and natural gas sectors. If your recommendations differ for a load-based or deliverer/first seller point of regulation in the electricity sector, or for the natural gas sector, explain why.

² Market Advisory Committee “Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California,” p. 55.

- Q2. Broadly speaking, should emission allowances be auctioned or allocated administratively, or some combination?
- Q3. If you recommend partial auctioning, what proportion should be auctioned? Should the percentage of auctioning change over time? If so, what factors should be used to design the transition toward more auctioning?
- Q4. How should new market entrants, such as energy service providers, community choice aggregators, or (deliverer/first seller system only) new importers, obtain emission allowances, i.e., through auctioning, administrative allocation, or some combination?

3.3. Auctioning of Emission Allowances—General Questions

These questions assume that some or all emission allowances are auctioned, and should be answered for both the electricity and natural gas sectors. If your recommendations differ for a load-based or deliverer/first seller point of regulation in the electricity sector, or for the natural gas sector, explain why.

- Q5. What are the important policy considerations in the design of an auction?
- Q6. How often should emission allowances be auctioned? How does the timing and frequency of auctions relate to the determination of a mandatory compliance period, if at all?
- Q7. How should market power concerns be addressed in auction design? If emission allowances are auctioned, how would the administrators of such a program ensure that all market participants are participating in the program and acting in good faith?
- Q8. What criteria should be used to designate the types of expenditures that could be made with auction revenues (including use to reduce end user rates), and the distribution of money within those categories?
- Q9. What type of administrative structure should be used for the auction? Should the auction be run by the State or some other independent entity, such as the nonprofit organization being established by the Regional Greenhouse Gas Initiative?

3.4. Electricity Sector

3.4.1. Administrative Allocation of Emission Allowances

Various methods have been proposed and discussed for the administrative allocation of emission allowances. The following potential methods could be used:

- a. Grandfathering: “A method by which emission allowances are freely distributed to entities covered under an emissions trading program based on historic emissions.” (MAC report, p. 93.)
- b. Benchmarking: “An allowance allocation method in which allowances are distributed by setting a level of permitted emissions per unit of input or output” (e.g., fuel used or sales to customers (pounds (lbs)/megawatt-hour or lbs/million British thermal units (MMBtu)). (MAC report, p. 90.)
- c. Updating: “A form of allowance allocation in which allocations are reviewed and changed over time and/or awarded on the basis of changing circumstances (such as output) rather than historical data (such as emissions, input or output). For example, allowances might be distributed based on megawatt-hours generated or tons of a product manufactured.” (MAC report, p. 96.)
- d. Other: Such as population (lbs of carbon dioxide (CO₂)/customer or lbs CO₂/capita), or cost of compliance (based on retail provider supply curves of emission reduction measures, or a comparable metric).

Answer each of the questions in this section, first, for a load-based system in the electricity sector and, second, for a deliverer/first seller system in the electricity sector. If your recommendations differ for a load-based or deliverer/first seller point of regulation, explain why.

- Q10. If some or all allowances are allocated administratively, which of the above method or methods should be used for the initial allocations? If you prefer an option other than one of those listed above, describe your preferred method in detail. In addition to your recommendation, comment on the pros and cons of each method

listed above, especially regarding the impact on market performance, prices, costs to customers, distributional consequences, and effect on new entrants.

- Q11. Should the method for allocating emission allowances remain consistent from one year to the next, or should it change as the program is implemented?
- Q12. If new market entrants receive emission allowance allocations, how would the proper level of allocations be determined for them?
- Q13. If emission allowances are allocated based on load/sales, population, or other factors that change over time, how often should the allowance allocations be updated?
- Q14. If emission allowances are allocated based on historical emissions (“grandfathering”) or benchmarking, what base year(s) should be used as the basis for those allocations?
- Q15. If emission allowances are allocated based initially on historical emissions (“grandfathering”), should the importance of historical emissions in the calculation of allowances be reduced in subsequent years as providers respond to the need to reduce GHGs? If so, how should this be accomplished? By 2020, should all allocations be independent of pre-2012 historical emissions?
- Q16. Should a two-track system be created, with different emission allowances for deliverers/first sellers or retail providers with legacy coal-fueled power plants or legacy coal contracts? What are the factors and trade-offs in making this decision? How would the two tracks be determined, e.g., using an historical system emissions factor as the cut-off? How should the allocations differ between the tracks, both initially and over time? What would be the market impact and cost consequences to consumers if a two-track method were used?
- Q17. If emission allowances are allocated administratively to retail providers, should other adjustments be made to reflect a retail provider’s unique circumstances? Comment on the following examples, and add others as appropriate:
 - a. Climate zone weighting to account for higher energy use by customers in inclement climates, and

- b. Increased emission allowances if there is a greater-than-average proportion of economically disadvantaged customers in a retail provider's area.
- Q18. Should differing levels of regulatory mandates among retail providers (e.g., for renewable portfolio standards, energy efficiency investment, etc.) be taken into account in determining entity-specific emission allowance allocations going forward? For example, should emission allowance allocations be adjusted for retail providers with high historical investments in energy efficiency or renewables due to regulatory mandates? If those differential mandates persist in the future, should they continue to affect emission allowance allocations?
- Q19. How often should the allowance allocation process occur? How far in advance of the compliance period?
- Q20. What are the distributional consequences of your recommended emission allowance allocation approach? For example, how would your method affect customers of retail providers with widely differing average emission rates? Or differing rates of population growth?

3.4.2. Emission Allowances with a Deliverer/First Seller Point of Regulation

- Q21. Would a deliverer/first seller point of regulation necessitate auctioning of emission allowances to the deliverers/first sellers?
- Q22. Are there interstate commerce concerns if auction proceeds are obtained from all deliverers/first sellers and spent solely for the benefit of California ratepayers? If there are legal considerations, include a detailed analysis and appropriate legal citations.
- Q23. If you believe 100% auctioning to deliverers/first sellers is not required, explain how emission allowances would be allocated to deliverers/first sellers. In doing so, answer the following:
 - a. How would the amount of emission allowances given to deliverers/first sellers be determined during any particular compliance period?
 - b. How would importers that are marketers be treated, e.g., would they receive emission allowance allocations or be

required to purchase all their needed emission allowances through auctions? If allocated, using what method?

- c. How would electric service providers be treated?
- d. How would new deliverers/first sellers obtain emission allowances?
- e. Would zero-carbon generators receive emission allowance allocations?
- f. What would be the impact on market performance, prices, and costs to customers of allocating emission allowances to deliverers/first sellers?
- g. What would be the likelihood of windfall profits if some or all emission allowances are allocated to deliverers/first sellers?
- h. How could such a system prevent windfall profits?

Q24. With a deliverer/first seller point of regulation, should administrative allocations of emission allowances be made to retail providers for subsequent auctioning to deliverers/first sellers? If so, using what allocation method? Refer to your answers in Section 3.4.1., as appropriate.

Q25. If you recommend allocation of emission allowances to retail providers followed by an auction to deliverers/first sellers, how would such an auction be administered? What kinds of issues would such a system raise? What would be the impact on market performance, prices, and costs to customers?

3.5. Natural Gas Sector

Q26. Answer each of the questions in Section 3.4.1. except Q16, but for the natural gas sector and with reference to natural gas distribution companies (investor- or publicly-owned), interstate pipeline companies, or natural gas storage companies as appropriate. Explain if your answer differs among these types of natural gas entities. Explain any differences between your answers for the electricity sector and the natural gas sector.

Q27. Are there any other factors unique to the natural gas sector that have not been captured in the questions above? If so, describe the issues and your recommendations.

3.6. Overall Recommendation

Q28. Considering your responses above, summarize your primary recommendation for how the State should design a system whereby electricity and natural gas entities obtain emission allowances if a cap and trade system is adopted.

4. Filing Requirements

All parties filing comments or replies should file them at the Public Utilities Commission's Docket Office and should serve them consistent with Rules 1.9 and 1.10 of the Public Utilities Commission Rules of Practice and Procedure and Resolution ALJ-188. The parties should serve their comments and legal briefs, and replies, on the service list for R.06-04-009 posted at www.cpuc.ca.gov when the filings are due, and should mail a hard copy of the filings to the assigned Commissioner and assigned Administrative Law Judges.

To support the ability of the Public Utilities Commission and the Energy Commission to develop joint recommendations to ARB, we ask that parties submit their comments and reply comments both in R.06-04-009 and to the Energy Commission's docket 07-OIIP-01.

Procedures for submitting the filings to the Energy Commission are included here for the parties' convenience. The Energy Commission encourages comments by e-mail attachments. In the subject line or first paragraph of the comments, include **Docket 07-OIIP-01**. When naming your attached file, please include your name or your organization's name. The attachment should be either in Microsoft Word format or provided as a Portable Document File (PDF). Send your comments to docket@energy.state.ca.us and to project manager Karen

Griffin at kgriffin@energy.state.ca.us. In addition to electronic filing, **one paper copy** must also be sent to:

California Energy Commission
Docket Office, MS-4
Re: Docket No. 07-OIIP-01
1516 Ninth Street
Sacramento, CA 95814-5512

IT IS RULED that:

1. As directed in this ruling, parties may file comments on the questions included in this ruling no later than October 31, 2007. Parties may file reply comments no later than November 14, 2007.
2. Parties shall file their comments and reply comments at the Public Utilities Commission's Docket Office and shall serve them consistent with Rules 1.9 and 1.10 and Resolution ALJ-188. The parties shall serve their filings on the service list for R.06-04-009 posted at www.cpuc.ca.gov when the filings are due, and shall mail a hard copy of the comments to the assigned Commissioner and the assigned Administrative Law Judges.
3. A workshop shall be held on allocation issues at 10 a.m., on November 5, 2007, at the Energy Commission, Hearing Room A, 1516 9th Street, Sacramento, California.

Dated October 15, 2007, at San Francisco, California.

JONATHAN LAKRITZ for
Charlotte F. TerKeurst
Administrative Law Judge

JONATHAN LAKRITZ
Jonathan Lakritz
Administrative Law Judge

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated October 15, 2007, at San Francisco, California.

JEANNIE CHANG

Jeannie Chang